LE COP

FILED
AUG 23 1972
MICHAEL RODAK, JR., CLE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972.

No. 72-235

KEITH B. McKY,

Petitioner,

vs.

OLGA HOCHFELDER, ET AL.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

WILLARD L. KING,
LEON M. DESPRES,
ALEX ELSON,
135 South La Salle Street,
Chicago, Illinois 60603,
Attorneys for Respondents.

THE BLAKELY PRINTING COMPANY, CHICAGO

INDEX.

	PAGE
The Petition Misstates the Facts	1-3
I. On Two Independent Bases for the Decision the Petition Makes no Claim of Error	3-4
II. The Decision Does Not Violate the Erie Doctrine	4
III. There Is no Conflict Between Circuits	5-7

CITATIONS.

Cases.

Henn v. Industrial Commission, 1954, 3 Ill. 2d 325, 327	4
Johns Hopkins v. Hutton, 1968, 297 F. Supp. 1165, 1210-12, 1236, affirmed CA 4, 422 F. 2d 1130	7
Kamen & Co. v. Paul H. Aschkar & Company, 1967, 382 F. 2d 689, 9th Cir. 1967	5-7
M. & J. Diesel Corp. v. Nettleton, 1965, 56 Ill. App. 2d 146, 151	4
Securities & Exchange Commission v. First Securities Company of Chicago, Appeal of Union Bank & Trust Company of Helena, Montana, ... F. 2d	App. B

United States Statutes.

Section 15 of the Securities Exchange Act of 1933, (15 U. S. C. 77n)	5-7
Securities Exchange Act of 1934,	
§ 10(b), 15 U. S. C. 78j(b)	5-7
§ 20(a), 15 U. S. C. 78t(a)	6

Rules and Regulations under the Securities Exchange Act of 1934,

Rule 10b-5, 17 CFR 240, 10b-5 3

Rule 27c of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. promulgated under section 15A, Securities Act of 1934, 15 U. S. C. § 7803 3

Miscellaneous.

Brief for the Securities & Exchange Commission filed by the Solicitor General of the United States on May 23, 1968 in the case of Aschkar v. Kamen, October Term, 1967, No. 4 .....App. B

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972.

No. 72-235.

KEITH B. McKY,

Petitioner,

vs.

OLGA HOCHFELDER, ET AL.,

Respondents.

BRIEF OF ESCROW CLAIMANTS IN OPPOSITION TO PETITION FOR CERTIORARI.

THE PETITION MISSTATES THE FACTS.

The case presented by petitioner's Statement of Facts is not the case scrupulously stated in the opinion of the Court of Appeals. The petition omits the most significant facts and misstates other facts.

The petitioner's Statement of Facts omits the fact that Nay was President of First Securities Company and the owner of 92% of its stock; that the escrow claimants had been long-time customers of First Securities Company; that Nay as President of First Securities constantly gave them investment advice; that Nay told the escrow claimants that the escrow opportunity had arisen because he had done a favor for a small investment company through First Securities. To fourteen of the fifteen claimants Nay first recom-

mended the investment in the escrow when the claimants were actually in the office of First Securities Company. Typically the escrow claimants sold their legitimate securities through First Securities to get the money to invest in the escrow. The claimants' receipts for their escrow investment and all correspondence with them regarding it was on the letterhead of First Securities. (Pet. A23-27.) Although Nay paid the interest on the escrow with his personal checks, they were transmitted in envelopes of First Securities Company. (TR. 17; 46; 80; 106; 136; 201; 458; 503; 539-40; 562; 607-8; 663-4.)

Only by omitting these facts can the petition state that the respondents clearly "understood that the escrow transactions were divorced from the business conducted by First Securities and agreed in writing to look solely to Nay for satisfaction of their claims." (Pet. p. 5) There is no basis in the record for this statement. Furthermore, the petitioner errs when he states, "The so-called 'escrow' was carried out by Nay without the knowledge . . . of any other . . . employee of First Securities Company". The record is replete with letters about the escrow dictated by Nay in the office of the Company to secretaries employed by the Company". (Tr. 218; 441; 463; 495; 684; 686-690; 714-5; 718-9; Ex. 156, 195, 200; Jackson Ex. 47; Voita Ex. 6; Smith Ex. 6-7; Feldkamp Exs. 4, 11, 12, 13, 18, 21, 26, 27, 31, 33.)

Petitioner is quite wrong when he says (Pet. p. 9): "Nay at no time told the respondents that First Securities had anything to do with the escrow or that it had any interest or participation therein or that he was acting in behalf of First Securities in obtaining funds for the escrow."

Actually:

1. He told claimant Hochfelder that "As President of

First Securities'' he had been given an opportunity to handle the escrow. (Tr. 57-9)

2. In attempting to convince claimant Lurena Stubbs not to purchase stock of Sears-Roebuck & Company, but instead to make a further investment in the escrow, Nay said to her that she had a better investment than Sears "through First Securities'' in the escrow. (Tr. 500-1)

3. He asked claimant Eric Stubbs not to divulge information about the escrow investment since it was a secret "between his Company'', i.e. First Securities, ''and the financial corporation''. (Tr. 488)

4. In 1968, just before Nay's suicide, after claimant Carnovsky had requested withdrawal of part of his escrow investment, Nay said to him, ''You have nothing to worry about. Your money is safe at First Securities.'' (Tr. 198)

I.

ON TWO INDEPENDENT BASES FOR THE DECISION THE PETITION MAKES NO CLAIM OF ERROR.

The opinion of the Court of Appeals is based on *four* independent alternative grounds:

1. First Securities Company is liable under the common law of Illinois. (Pet. A. 27-29.)

2. First Securities Company did not act in good faith as a ''controlling person'' of Nay. (Pet. A. 30-31.)

3. First Securities Company is liable as an aider and abettor of Nay's fraud under § 10b of the Securities Act of 1934 and Rule 10b 5 of the SEC. (Pet. A. 32-33.)

4. First Securities Company is liable for its failure to comply with Rule 27 (c) of the Rules of Fair Practice of the National Association of Securities Dealers. (Pet. A. 33.)

The decision of the Court of Appeals is *independently* based on each one of these grounds.

The petition for certiorari nowhere suggests that there was any error in the third and fourth bases for the decision. It limits its claim of error to the first two of these bases.

II.

THE DECISION DOES NOT VIOLATE THE ERIE DOCTRINE

This is perhaps the first time that a decision of a Court of Appeals, on state law, based upon the Restatement of the American Law Institute, has been claimed to violate the Erie doctrine. The Court of Appeals stated: "There is no direct authority in point in the Illinois case law, but we are convinced that the Illinois courts would not differ on this issue from the rule stated in the Restatement and the *Blackburn* case." (Pet. A. 29.) The *Blackburn* case was not cited as an "isolated" case as the petition claims, (Pet. 12) but because it was expressly based upon the Restatement and it applied the Restatement to facts strikingly similar to those of the case at bar. (Pet. A. 27-29.) The Illinois courts have adopted the Restatement of Agency in many cases (*Henn* v. *Industrial Commission*, 1954, 3 Ill. 2d 325, 327; *M. & J. Diesel Corp.* v. *Nettleton*, 1965, 56 Ill. App. 2d 146, 151).

After the decision in the case at bar, another panel of the Court of Appeals for the 7th Circuit reversed another decree of the District Court denying a large investor's claim in the First Securities case. This reversal was on the same four bases as the reversal which Petitioner now seeks to attack. (See opinion attached, Appendix A.)

The Illinois cases cited by the petitioner are irrelevant on their facts.

III.

THERE IS NO CONFLICT BETWEEN CIRCUITS.

Petitioner argues that certiorari must be granted because there is a conflicting decision in the 9th Circuit (*Kamen & Co.* v. *Paul H. Aschkar & Company*, 382 F. 2 689, 9th Circuit, 1967). However, this is not a citable case.

Aschkar was a California broker buying and selling unlisted securities. Kamen was a member of the New York Stock Exchange dealing in listed securities. A rule of the NYSE forbade direct or indirect rebates of commissions. To thwart this rule and to increase Kamen's commissions on listed sales, two Kamen employees concocted a scheme.

These employees telephoned brokers dealing in unlisted securities and suggested their purchase of stock which these employees owned in a worthless corporate shell. They instructed Broker A what price he should pay for the shares and guaranteed that the shares could be re-sold to Broker B at a slightly higher price. They told Broker B to buy from Broker A and resell to Broker C for a fixed fractional markup. This created a continuing chain in which each buying and selling broker was guaranteed a profit in return for giving listed securities business to Kamen. For a time this scheme succeeded. Kamen received large commissions on his increased listed-stock business generated by this project. But the SEC discovered the scheme, investigated and denounced it. Aschkar was left holding worthless stock for which it had paid some $25,000 and which its guaranteed buyer refused to take. Sixteen other dealers in unlisted securities were in the same predicament. (Aschkar Pet. Cert. October Term, 1967, No. 665, later No. 4, Appendix G.)

Aschkar sued Kamen for the fraud of Kamen's employees. The District Court held that Kamen did not know of the fraud of his employees and therefore was not liable

to Aschkar under the Securities Acts but was liable for common law fraud. This judgment was reversed by the 9th Circuit Court of Appeals on the ground that Aschkar had been previously employed by a NYSE broker and knew that the rule of that Exchange forbade direct or indirect rebates. Aschkar therefore could not have assumed that Kamen's employees were acting within the scope of their authority. All this was on the basis of the common law.

However, Aschkar had taken a protective cross-appeal relying *inter alia* on § 15 of the 1933 Securities Act and § 20a of the 1934 Securities Act imposing liability for fraud of controlling persons. The Court of Appeals held that since the test of such liability was that the controlling person had acted in bad faith and had directly or indirectly induced the fraud, Kamen was not liable under these sections because he had no knowledge of the fraud.

Aschkar filed a petition for certiorari in this Court. This Court then invited the Solicitor General to file a brief expressing the views of the United States.(December 4, 1967, 389 U. S. 966.) Solicitor General Griswold filed a memorandum with this Court recommending that certiorari be allowed, because the legislative history clearly showed that the exculpatory clauses for "controlling persons" who acted in good faith had no application to a broker's liability for violation by its employees of the Securities Acts. That liability was absolute. He said that the decision thus unduly impeded private rights of action for violation of the Securities Acts which were necessary to the enforcement of those Acts.

Certiorari was then allowed and the case was placed on the summary calendar (March 4, 1968, 390 U. S. 942.) The Solicitor General and the attorneys for the SEC then filed such a devastating brief (copy attached hereto as Appendix B) that Kamen could not refute it and made restitution not only to Aschkar, but to the 16 other unlisted stock brokers

who had filed similar suits in New York. It will be noted that the Solicitor General and the SEC (App. B pp. 13-17) do not agree with the summary purported legislative history which the Petitioner here presents. (Pet. p. 17.)

The petition for certiorari was then (September 3, 1968, 393 U. S. 901) dismissed under Rule 60, and the opinion of the Court of Appeals no longer had any authority as a precedent. For a short time it was cited in a few cases, but only to distinguish it. (See distinction of it by Kaufman, J., in *Johns Hopkins* v. *Hutton*, 1968, 297 F. Supp. 1165, 1210-12, 1236, affirmed C. A. 4, 422 F. 2d 1124, 1130: "For reasons fully stated by Judge Kaufman we agree that Section 15 of the Act (15 U. S. C. § 77o) was not intended to insulate a brokerage house from the misdeeds of its employees.") No court has ever followed *Kamen* v. *Aschkar* in its interpretations of § 15 of the 1933 Securities Act and § 20a of the 1934 Securities Act. The District Court expressed the same erroneous interpretation in the case at bar (Pet. A. 21-22), but the District Court did not cite *Kamen*. No citation of it is recorded in the latest citator.

It is submitted that certiorari should be denied.

Respectfully submitted,

WILLARD L. KING,
ALEX ELSON,
LEON M. DESPRES,
135 South La Salle Street,
Chicago, Illinois 60603,
Attorneys for Respondents.

In the
United States Court of Appeals
For the Seventh Circuit

SEPTEMBER TERM, 1971 — APRIL SESSION, 1972

No. 71-1422

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

v.

FIRST SECURITIES COMPANY OF CHICAGO,
Defendant.

UNION BANK & TRUST COMPANY, HELENA, MONTANA,
Claimant-Appellant,

KEITH S. MCKY,
Receiver-Appellee,

CUSTOMER CREDITORS COMMITTEE,
Committee-Appellee.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 68 C 1053

JULIUS J. HOFFMAN,
Judge.

ARGUED APRIL 13, 1972 — DECIDED AUGUST 1, 1972

Before HAMLEY,* STEVENS and SPRECHER, *Circuit Judges.*

SPRECHER, *Circuit Judge.* This is another sad chapter in the case of Leston B. Nay and the frauds he perpetrated over a long period of years against a great number of innocent investors. The record in this court in the prior appeal of 15 individual escrow participants, Olga Hoch-

* Circuit Judge Frederick G. Hamley of the United States Court of Appeals for the Ninth Circuit is sitting by designation.

felder et al., has been made part of the record in this appeal. *SEC* v. *First Securities Co.*, ... F.2d ..... (No. 71-1272, April 12, 1972).

The defendant in the equitable receivership, First Securities Company of Chicago, was registered with the Securities and Exchange Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers. On June 4, 1968, Leston B. Nay, president of First Securities and owner of 92 percent of its stock, murdered his wife and committed suicide. He left a suicide note which described First Securities as bankrupt because of his thefts and which characterized the "Schueren account" as being one of "the thefts affecting the Company."

On June 10, 1968, the SEC initiated the receivership action against First Securities. The claim which is the subject matter of this appeal derives from Nay's theft of securties owned by Arnold C. Schueren. The district court appointed a special master to hear and determine the validity of the various claims against First Securities. In accordance with the recommendation and findings of the special master, the district court disallowed the instant claim on behalf of the estate of Arnold C. Schueren in its entirety, and this appeal followed.

I

On April 16, 1936, Arnold C. Schueren appointed Nay "to act for me in connection with all matters arising out of or in any way connected with my securities to the same extent and with the same full power and authority as I might personally do if present." On July 7, 1937, "[w]ithout detracting from the general and specific powers contained in that instrument [of April 16, 1936], I further authorize and empower the said Leston B. Nay to sign in my behalf any proxies, transfers, acknowledgments, accounts, receipts or documents for my securities with the same power and authority as I would myself if present."

In July, 1939, Schueren received a letter headed "Webber, Darch & Company, Leston B. Nay, President" and signed Webber, Darch & Company "by Leston B. Nay." The letter stated, "In accordance with your recent request we

are pleased to enclose inventory of securities held in safe keeping for your account"; an itemized inventory was enclosed.

Nay joined Ryan-Nichols & Co. as vice-president in 1942. Schueren received a letter dated July 31, 1942, on the letterhead of Ryan-Nichols & Co., signed Ryan-Nichols & Co. "by Leston B. Nay, Vice President." It said, "We have received from Webber, Darch & Co. the following securities, which we placed in safe keeping for your account;" following was an itemized list of securities. The name of Ryan-Nichols & Co. was changed to First Securities Company of Chicago on June 24, 1944, at about which time Nay became president and principal shareholder.

From 1946 through 1963, First Securities bought and sold securities for Schueren in *bona fide* transactions which appeared in the books and records of First Securities and which were not tainted by any defalcations of Nay. In connection with these transactions, Schueren received confirmations on the printed forms of First Securities.

For all his securities Schueren received safekeeping receipts. Those appearing in the record were on the printed forms of First Securities and acknowledged receipt by "First Securities Company of Chicago" and showing the typed names and written initials of Campbell, Burke and Walker.

Each month Schueren would receive an itemized list of dividends received on the securities purportedly in safekeeping for him, together with a cashier's check for the month's total dividends. Although a few of the dividend itemizations were on otherwise blank paper, the great majority were typed on the printed letterhead of First Securities with the further printed designation "Member, Midwest Stock Exchange."

Under date of March 17, 1959, Schueren received a complete inventory of his purported holdings, typed on the letterhead of First Securities. Schueren found three discrepancies between his own records of his holdings and those on the March 17 inventory list. He pointed them out to Nay, who wrote Schueren a letter dated March 26, 1959, on the printed letterhead of First Securities, acknowledging the three errors and ascribing them to the typist.

Schueren died in 1967; the Union Bank and Trust Company was appointed his executor. The bank then wrote Nay requesting all of Schueren's securities. On April 27, 1967, Nay sent the bank what purported to be a complete inventory of the Schueren holdings, typed on sheets stamped with the name of First Securities. For more than a year, Nay corresponded with the bank and pretended to be in the process of obtaining transfers of the Schueren securities. When on June 4, 1968, he finally told the bank that the security transfers had been completed and were ready for delivery, he committed suicide. Thereafter the bank learned of Nay's thefts of the securities involved in this claim, which were valued at $394,195.39.

II

Because of the legal conclusions reached in the Hochfelder appeal, it is important to consider the factual basis from which they derived. This court said in *SEC* v. *First Securities Co.*, ... F.2d ..... (No. 71-1272, April 12, 1972), in the slip opinion at pages 2-5:

> "The fifteen claimants had each been brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion. Each received investment advice from Nay, and each knew Nay to be the president of First Securities. Nay advised each of the claimants that he was able to offer to the claimant an opportunity to invest in a so-called escrow which would yield a high rate of interest. . . . . Typically, upon being persuaded by Nay that the escrow was the best possible investment for them, the claimants sold legitimate securities through First Securities for purposes of obtaining the necessary cash to invest in the escrow. First Securities effected the sales, collected its commissions and submitted the proceeds to the claimants, who then drew their personal checks payable to Nay or to a bank for his account. Subsequent transactions with regard to the escrow were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the claimants.

"Upon receipt of the cash investment from the claimants, Nay usually executed a hand-written document which acknowledged such receipt and confirmed the terms of the arrangement. Sometimes Nay gave promissory notes to the claimants. All, or substantially all, of Nay's correspondence with the claimants was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, 'Leston B. Nay, President,' on the upper left hand portion thereof. All of the stationery bore the legend, 'Member Midwest Stock Exchange,' in addition to the firm's name and address. Although much of Nay's correspondence with regard to the escrow transactions was handwritten by him, a substantial portion was typed by his secretary at First Securities.

"During the early years of Nay's fraudulent enterprise, the claimants were paid interest from time to to time based upon their 'investments' in the escrow. Such payments were made by Nay's personal check. . .

"Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its existence. Nay had forbidden anyone other than himself to open mail addressed to him, and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention."

On the basis of the above facts, this court concluded that (1) Nay acted with apparent authority as the common law agent of First Securities; (2) First Securities was a "controlling person" as to Nay within the intention of section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a); (3) First Securities at least aided and abetted Nay in violating section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated pursuant thereto, 17 C.F.R. §240.10b-5; and (4) First Securities failed to satisfy its duty to supervise Nay pursuant to Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. This court held that First Securities was liable for Nay's fraud to the 15 escrow participants on all four theories.

III

The parties to this appeal, with a commendable willingness to disclose everything which has occurred in the equitable receivership, included in the record here the evidence relating to, and the disposition by the special master (approved by the district court) of two other pertinent claims.

Norman L. Moyer had appointed Nay executor of his will. When Moyer died on March 3, 1958, Nay as executor took custody of his stocks and bonds. In his final account filed in the probate court, Nay recited that the securities had been distributed to the widow, Nora A. Moyer; actually Nay had delivered to her a safekeeping receipt with a First Securities stamp thereon. The securities never appeared in the records of First Securities and were missing at the time Nay took his life. In recommending allowance of the Moyer claim, the special master concluded:

> "The question . . . is whether the transactions purported to have been carried out, on the broker's side, by Mr. Nay individually or by him on behalf of First Securities. And to this question there is a clear answer: The receipt which was signed in the name of First Securities and which contained a First Securities stamp at the top of each page, and the quarterly statements furnished to Mrs. Moyer as an accounting of dividends and interest received, clearly purported to be documents of First Securities. No question is raised as to Mr. Nay's authority to act as agent and validly sign for First Securities. And Mr. Nay, in his death note, listed the Moyer theft as 'affecting the Company'.
>
> "Furthermore, even if the matter is looked at from the point of view of Mrs. Moyer's intentions, there are indications that Mrs. Moyer relied on First Securities so far as the safekeeping of the securities was concerned. . . ."

A second claim recommended for allowance by the special master and allowed by the district court was that of Arnold C. Schueren's wife, Eleanore A. Schueren, whose relation to Nay and First Securities was similar

to that of her husband except that she had signed no power of attorney.

In allowing the claim of Mrs. Schueren, the district court concluded:

> "Mrs. Schueren's dealings with Nay were similar to those of Nora A. Moyer, whose claim has previously been allowed by the court. Mrs. Schueren received documents purporting to be safekeeping receipts and monthly statements of her account, all on First Securities forms or letterheads. Thus, the preponderance of the evidence establishes that Nay had apparent authority to deal with Mrs. Schueren as the agent of First Securities, and that Mrs. Shueren intended to deal with him in that capacity. I agree with the Special Master's view that the fact that payments were made by cashier's check is not sufficient to negate Nay's apparent authority, or to raise such suspicion as to cause a person using due diligence to discover that Nay did not have actual authority to act for First Securities in those transactions."

IV

Consideration of the facts leading this court to conclude that the claims of the 15 escrow participants against First Securities should be allowed and of the facts leading the special master and the district court to allow the Moyer and Eleanore Schueren claims, causes us to conclude that the Schueren claim should also be allowed despite the existence of the power of attorney.

The power of attorney was executed by Schueren in 1936 and supplemented in 1937. The power and supplement were typewritten forms in which Schueren's name was inserted in handwriting. There is nothing in the voluminous record before us to indicate that Schueren was ever again reminded of the existence of the power of attorney after 1937.

The only evidence in the record which reflects Schueren's intention and understanding is a memorandum dated May 31, 1957, addressed to the Union Bank & Trust Company, in which he refers to the location of the safekeeping receipts:

> "All of our securities, with the exception of a few common stocks are held in Safe keeping by the FIRST SECURITIES COMPANY, 134 South LaSalle Street, Chicago, 3, Ill. Mr. Leston B. Nay is President of this Company."

Like the escrow participants, Schueren was a *bona fide* customer of First Securities quite aside from the tainted Nay transactions. First Securities bought and sold securities for him, he issued his checks payable to First Securities, he received valid confirmations and other documents from First Securities and the books and records of the company reflected these untainted transactions.

What after Nay's death proved to be scores of spurious safekeeping receipts and spurious monthly dividend statements and the spurious inventories in 1959 and 1967 were on the genuine letterheads and forms of First Securities, were apparently in proper order, were often signed by Nay who had "authority to act as agent and validly sign for First Securities," or with the names and initials of persons who were or seemed to be actual officers or employees of First Securities (Campbell, Walker, Burke). Schueren himself kept meticulous books and records. Nothing which occurred during the almost 25 years of Schueren's dealings with First Securities and Nay can be said to have put a reasonable person on notice that anything was amiss. Nay's manipulations of the fraudulent records which were sent to Schueren at least monthly coincided with Schueren's own records of what he believed he owned. Even the trust department of the Union Bank was completely duped by Nay for more than a year after Schueren's death until Nay's suicide.

Nay believed that in his dealings with Schueren he was acting as the agent for First Securities. In his suicide note he said, "The thefts affecting the Company are 1) The Schueren acc't. (Union Bank of Helena . . .) 2) Moyer acc't." He gave detailed instructions to Roy Campbell, the cashier of First Securities, as to where the Schueren files and papers were located.

There is no evidence that anyone at First Securities other than Nay was ever aware of the 1936-37 Schueren power of attorney. There is no evidence that the power

was ever used by Nay. Although it may be speculated that it was used, the facts are that Nay was able to dispose of the Moyer and Eleanore Schueren securities without using or even possessing a power of attorney from them.

As we stated in the prior appeal (slip opinion, page 10):

> "Here, First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of frauds of the type which occurred."

First Securities also provided Nay with the printed letterheads, printed safekeeping receipts, rubber stamps and other supplies and accoutrements which enabled him to perpetrate and perpetuate his frauds.

For the four reasons upon which this court allowed the escrow claims in the prior appeal, we conclude that this claim should also have been allowed.

The judgment of the district court is reversed.[1]

A true Copy:

Teste:

.....

Clerk of the United States Court of Appeals for the Seventh Circuit.

[1] The only case relied upon by the special master and the district court to reach a contrary conclusion, *Rosen* v. *Hardy*, 238 App. Div. 622, 265 N.Y.S. 154 (1933), was decided by an intermediate state appellate court prior to the enactment of the Securities Exchange Act of 1934, was not concerned with the unique facts present here and apparently has never been cited since its issuance some 40 years ago.

USCA 4013—The Scheffer Press, Inc., Chicago, Illinois—8-1-72—200

INDEX

	Page
The interest of the Securities and Exchange Commission	1
Statement	3
Summary of argument	9
Argument:	
I. The liability of a broker-dealer firm for violations of the antifraud provisions of the federal securities laws by employees of the firm, acting within the scope of their employment, is not governed or restricted by the "controlling-persons" provisions of those laws	10
II. A violation of the antifraud provisions of the securities acts by a broker-dealer's employees, acting within the scope of their employment, is necessarily a violation by the firm itself	17
A. A broker-dealer's responsibility under the federal securities laws in such circumstances should be determined as a matter of uniform federal law in accordance with the underlying statutory purposes	17
B. The overriding objectives of the securities laws would best be advanced by holding broker-dealers liable as a matter of course for the frauds of their employees practiced within the scope of their employment	20

Page
Conclusion 27
Statutory Appendix 29

CITATIONS

Cases:

A. T. Brod & Co. v. *Perlow*, 375 F. 2d 393 25
Azalea Meats, Inc. v. *Muscat*, 386 F. 2d 5 19
Brown v. *Bullock*, 294 F. 2d 415 19
Cady, Roberts & Co., 40 S.E.C. 907 22
Clearfield Trust Co. v. *United States*, 318 U.S. 363 18
Colonial Realty Corp. v. *Bache & Co.*, 358 F. 2d 178, *certiorari denied*, 385 U.S. 817 26
D'Oench Duhme & Co. v. *Federal Deposit Insurance Corporation*, 315 U.S. 447 19
E. H. Rollins & Sons, Inc., 18 S.E.C. 347 22
Egan v. *United States*, 137 F. 2d 369, *certiorari denied*, 320 U.S. 788 23
Ellis v. *Carter*, 291 F. 2d 270, *dismissal affirmed*, 328 F. 2d 573 11
Fischman v. *Raytheon Mfg. Co.*, 188 F. 2d 783 11
Frost & Co. v. *Mines Corp.*, 312 U.S. 38 20
H. F. Schroeder & Co., 27 S.E.C. 833 22
Hooper v. *Mountain States Securities Corp.*, 282 F. 2d 195, *certiorari denied*, 365 U.S. 814 25
J. I. Case Co. v. *Borak*, 377 U.S. 426 ..... 3, 11, 19, 20
Janigan v. *Taylor*, 344 F. 2d 781, *certiorari denied*, 382 U.S. 879 19
Jerome, Richard & Co. (Securities Exchange Act Release No. 7688, Aug. 27, 1965) 2
Kamen & Co. (Securities Exchange Act Release No. 7965, Sept. 29, 1966) 2
National Association of Securities Dealers, Inc., 20 S.E.C. 508 22

Cases—Continued

	Page
New York Central R.R. v. *United States*, 212 U.S. 481	23
Pope & Talbot, Inc. v. *Hawn*, 346 U.S. 406	20
Securities and Exchange Commission v. *Capital Gains Bureau*, 375 U.S. 180	16, 21
Securities and Exchange Commission v. *Joiner Corp.*, 320 U.S. 344	17
Securities and Exchange Commission v. *Kamen & Co.*, 63 Civ. 2331 (S.D.N.Y.) (Litigation Release Nos. 2705, Aug. 5, 1963; 2742, Sept. 16, 1963; 2948, May 28, 1964; and 3009, Aug. 27, 1964)	2
Securities and Exchange Commission v. *Variable Annuity Co.*, 359 U.S. 65	19
Sola Electric Co. v. *Jefferson Co.*, 317 U.S. 173	20
Tcherepnin v. *Knight*, 389 U.S. 332	16, 19
Textile Workers v. *Lincoln Mills*, 353 U.S. 448	19, 20
United States v. *A & P Trucking Co.*, 358 U.S. 121	23
United States v. *Herman*, 67 Cr. 946 (S.D.N.Y.) (Litigation Release No. 3974, April 11, 1968)	2
Wilko v. *Swan*, 346 U.S. 427	24
Wyandotte Co. v. *United States*, 389 U.S. 191	11

Statutes and rules:

Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*:	
Section 2(2), 15 U.S.C. 77b(2)	12
Section 11, 15 U.S.C. 77k	17, 29
Section 12(2), 15 U.S.C. 77*l*(2)	3, 8, 10, 11, 17, 29
Section 14, 15 U.S.C. 77n	24, 30
Section 15, 15 U.S.C. 77o	8, 11, 14, 15, 30
Section 17(a), 15 U.S.C. 77q(a)	3, 8, 13, 30

Statute and rules—Continued Page
Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*:
Section 2, 15 U.S.C. 78b 18, 31
Section 3(a)(9), 15 U.S.C. 78c(a)(9) 12
Section 10(b), 15 U.S.C. 78j(b) 3, 8, 10, 32
Section 15(b)(5)(E), 15 U.S.C. 78o(b)(5)(E) 22, 32
Section 15(c)(1)–(3), 15 U.S.C. 78o(c)(1)–(3) 3, 8, 10, 33
Section 20(a), 15 U.S.C. 78t(a) 8, 11, 14, 15, 34
Section 29(a), 15 U.S.C. 78cc(a) 24, 35
Rules and Regulations under the Securities Exchange Act of 1934, 17 CFR 240.0–1, *et seq.*:
Rule 10b–3, 17 CFR 240.10b–3 35
Rule 10b–5, 17 CFR 240.10b–5 35
Rule 15c1–2, 17 CFR 240.15c1–2 36
Miscellaneous:
H. Conf. Rep. No. 152, 73d Cong., 1st Sess. 14
H. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 15
H.R. 5480, 73d Cong., 1st Sess. (May 4, 1933) 13
H. Rep. No. 85, 73d Cong., 1st Sess. 21
Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), 73d Cong., 1st Sess. 14
Message from the President of the United States, H. Doc. No. 12, 73d Cong., 1st Sess. 17, 21
Report of Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. 18, 25
Restatement, *Agency* (1933) 16
Restatement (Second), *Agency* (1957) 15, 16

Miscellaneous—Contiued

	Page
S. 875, 73d Cong., 1st Sess (April 17, 1933) 77 Cong. Rec. 2979	13
S. Rep. No. 47, 73d Cong., 1st Sess	13
Securities Act Release No. 4723 (Sept. 16, 1964)	2
Securities Exchange Act Release No. 8239 (Jan. 26, 1968)	25

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 665

PAUL H. ASCHKAR & CO., PETITIONER

v.

KAMEN & CO., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. 78a *et seq.*, provides a comprehensive scheme for the regulation of securities brokers and dealers. The Securities and Exchange Commission is the agency charged with the administration and enforcement of this regulatory scheme. It has promulgated the rules and regulations involved in this case and has itself previously taken enforcement actions against respondents (and others of the defendants below) for

their participation in the activities involved in this case.[1]

In a memorandum filed at the invitation of the Court, we urged that the petition for certiorari be granted. We indicated that the decision of the court of appeals that respondents are not liable under the federal securities laws for the fraudulent acts of their employees, acting within the scope of their employment, is inconsistent with the position the Commission

[1] When these fraudulent activities came to light, the Commission sought injunctions against respondents Kamen & Co. and Abraham Kamen, and defendants Laurence H. Ross ("Ross"), Jerome M. Grossinger ("Grossinger") and Frederick Cirlin Associates, Inc., as well as against Jerome, Richard & Co., Inc. ("J-R" hereafter). It obtained permanent injunctions against Ross and Grossinger by default and against Frederick Cirlin Associates, Inc., by consent, and preliminary injunctions against Kamen & Co. and Abraham Kamen by consent and against J-R on a litigated motion. *Securities and Exchange Commission* v. *Kamen & Co.*, 63 Civ. 2331 (S.D.N.Y.); Litigation Release Nos. 2705 (Aug. 5, 1963), 2742 (Sept. 16, 1963), 2948 (May 28, 1964) and 3009 (Aug. 27, 1964). An exemption from registration under the 1933 Act covering the securities of J-R was suspended (Securities Act Release No. 4723, Sept. 16, 1964). Administrative disciplinary proceedings were instituted by the Commission against various defendants in this case. The registration of J-R as a broker-dealer was revoked, and Grossinger was barred from being associated with any broker or dealer. *Jerome, Richard & Co.*, Securities Exchange Act Release No. 7688 (Aug. 27, 1965). Respondent Kamen & Co. was suspended from membership in the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers, Inc., for 10 business days; respondent Abraham Kamen was suspended from being associated with any broker or dealer for 90 days; and the registration of Frederick Cirlin Associates, Inc., as a broker-dealer was revoked. *Kamen & Co.*, Securities Exchange Act Release No. 7695 (Sept. 29, 1966) (Pet. Br. App. 2). Finally, Ross was indicted for and pleaded guilty to violations of the federal securities laws. *United States* v. *Herman*, 67 Cr. 946 (S.D.N.Y.), Litigation Release No. 3974 (April 11, 1968).

has long taken in its administrative disciplinary proceedings, that a broker-dealer firm has necessarily violated those laws in such circumstances (see p. 22, *infra*). In the Commission's view the decision below unduly impedes private rights of action for violations of the federal securities laws, which this Court described as a "necessary supplement" to the Commission's own enforcement powers. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. This brief is submitted to set forth the reasons for the Commission's position on the merits of this case.

STATEMENT

1. Petitioner is a broker-dealer that is not a member of a securities exchange. It brought this action against respondents Kamen & Co. and two of its general partners for damages resulting from certain allegedly fraudulent practices perpetrated by Kamen & Co. through two employees of the firm.[2] The claims for relief were based on the express private right of action for damages in Section 12(2) of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. 77*l*(2), and on implied rights of action for violations of Section 17(a) of the 1933 Act, 15 U.S.C. 77q(a), Sections 10(b) and 15(c)(1)-(3) of the 1934 Act, 15 U.S.C. 78j(b), 78o(c)(1)-(3), and the rules and regulations promulgated by the Commission under the latter two

[2] Default judgments were obtained against the other defendants named: the two employees of Kamen & Co. (Ross and Grossinger), and the securities firm of Frederick Cirlin Associates, Inc. (R. 57).

sections.[3] Relying also on diversity of citizenship and pendent jurisdiction, petitioner alleged the same facts as a basis for relief under the statutory and common law of the State of California. After a full trial the district court, sitting without a jury, ruled that respondents Kamen & Co. and its partners were not liable under the securities acts but were liable under agency principles of California law. The court of appeals reversed the latter ruling, holding that the respondents were not liable under either state or federal law.

2. The fraudulent activities occurred in connection with an effort by Kamen & Co., a member of the New York and the American Stock Exchanges, to obtain business from nonmember securities firms in securities listed on these exchanges.[4] Early in 1963, Kamen & Co. hired two registered representatives, Ross and Grossinger, on the basis of the latters' assurances that they could substantially expand the firm's volume of business by soliciting orders in listed securities from nonmember brokerage firms, if Kamen & Co. would offer certain special services to such firms. Pursuant to this arrangement, Kamen & Co. established a Broker-Dealer Division headed by Ross and Grossinger and gave them authority to solicit business in

[3] The pertinent provisions of the securities acts and the rules and regulations promulgated by the Commission under those acts are reprinted in the appendix to this brief (see pp. 29–36, *infra*).

[4] Securities firms that are not members of these exchanges may have transactions for customers executed on the exchanges only by using the services of a member firm, and they must pay the member firm the same minimum commission as any nonprofessional investor.

listed securities from nonmember firms and to place over-the-counter orders with those firms, presumably to encourage reciprocal business in securities listed on the exchanges.

Ross and Grossinger substantially increased Kamen & Co.'s listed business from nonmember broker-dealers. This business grossed more than $180,000 in commissions for Kamen & Co., of which the firm's share was $36,000. In obtaining this business, however, Ross and Grossinger offered more than the special services actually authorized by respondents. They also offered the nonmember firms "guaranteed" profits by executing over-the-counter transactions in the stock of a shell corporation, J–R. The nonmember firms were not told that J–R stock was intrinsically worthless, that the corporation was controlled by Ross and Grossinger, or that the over-the-counter transactions in the stock were contrived.

Essentially, the fraudulent scheme devised by Ross and Grossinger involved a telephone call to nonmember broker-dealer B to instruct it to buy for its own account a block of J–R stock from nonmember broker-dealer A at a stated price and to sell it immediately to nonmember broker-dealer C at a designated fraction of a point markup. Ross and Grossinger impliedly represented that the transactions were for bona fide orders received by Kamen & Co.; and at least in some instances, including those involving petitioner, they expressly represented that Kamen & Co. guaranteed performance by the other nonmember firms according to the terms specified. There were no

direct communications between A and B or B and C other than subsequent confirmations, payments and deliveries of the securities. After making this arrangement with B, Ross or Grossinger would then call nonmember broker-dealer C and, making similar representations, instruct it to buy from B at the last price and sell to nonmember broker-dealer D at an additional fraction of a point markup. Similar arrangements with other nonmember broker-dealers would and did result in numerous chains of transactions in the worthless J-R securities, at ever-increasing prices within each chain and with each broker-dealer recovering his purchase price plus a small profit as long as the chain continued.[5]

Petitioner was one of the nonmember broker-dealers that were persuaded to commit themselves to the over-the-counter transactions arranged by Ross and Grossinger. On July 10, 1963, pursuant to telephone instructions from Ross and Grossinger, petitioner purchased 700 shares of J-R stock from one broker-dealer at $19.25 per share and agreed to sell them to another broker-dealer at $19.375. On July 17, again pursuant to instructions from Ross and Grossinger,

[5] Neither of the courts below discussed the financial arrangements for keeping these chains in operation. The Commission's opinion in the administrative proceeding against respondents (see p. 2, n. 1, *supra*) indicates that the chains were designed to end in broker-dealers affiliated with Ross and Grossinger (Pet. Br. App. 2, pp. 11, 12). This was apparently feasible since Ross and Grossinger received about 40 percent of the exchange commissions that they generated, and the guaranteed profits given to the nonmember broker-dealer customers through these contrived over-the-counter transactions usually ran about 23 percent of the exchange commissions that the customers paid (Pet. Br. App. 2, pp. 10, 15).

petitioner agreed to purchase 1000 shares at $19.25 and to sell them at $19.50; and on the same day it also purchased another 600 shares, these at $19.00 per share, which were to be sold at $19.25 per share. On or about July 24, 1963, the fraudulent scheme described above became known in the securities industry. Although petitioner did not complete the July 17 agreement to purchase 1000 shares, it had paid $24,875 for the 1300 shares it purchased. When the securities firms that were to have purchased these 1300 shares from petitioner refused to consummate the transactions, petitioner missed out not only on the riskless profit promised by Ross and Grossinger on these shares (less than $500); it suffered an out-of-pocket loss of approximately $25,000.

3. In ruling on the issues of state law the district court made the following findings, as summarized by the court of appeals (R. 67): (1) the fraudulent scheme "was carried out by Ross and Grossinger as an object of their employment, *i.e.*, to secure listed business, and therefore within the scope of their employment;" (2) "Ross and Grossinger had no actual authority to offer or place fraudulent Jerome stock or make any misrepresentations concerning such transactions * * *;" (3) respondents "did not know and had no reason to know of the fraudulent acts of the[ir] agents;" (4) Ross and Grossinger had "ostensible authority to offer and place such transactions and make the representations * * *" and (5) "Aschkar [petitioner] was justified in relying on the ostensible authority of Ross and Grossinger * * *."

The court of appeals set aside the findings of ostensible authority and justifiable reliance as "clearly erroneous," concluding that in the light of petitioner's professional experience and the "unusual nature" of the transactions it should have made inquiry as to "the extent of authority of the agent." Accordingly, it reversed the holding that respondent was liable under state law for the fraud of its employees (R. 68–72).

In ruling on the issues of federal law the district court had concluded that the activities of Ross and Grossinger violated Section 17(a) of the 1933 Act, Sections 10(b) and 15(c)(1)–(3) of the 1934 Act and the pertinent rules under the latter sections and also created liability under Section 12(2) of the 1933 Act (R. 55). The court of appeals did not question this conclusion but assumed that the only premises for holding Kamen & Co. and its partners responsible for those violations were the so-called "controlling-persons" provisions in Section 15 of the 1933 Act, 15 U.S.C. 77o, and in Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a), which provide that "[e]very person who * * * controls any person liable * * *" under the acts "shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable * * *." Since these sections, however, except cases in which "the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist" (1933 Act), or when "the controlling person acted in good faith

and did not directly or indirectly induce the act or acts constituting the violation or cause of action" (1934 Act), the court of appeals held in accordance with the district court's findings of fact that respondents were not liable under the securities laws for the violations by Ross and Grossinger. (R. 67–68).

SUMMARY OF ARGUMENT

The "controlling-persons" provisions of the securities laws were not designed to deal with customary employer-employee relationships but to remove artificial barriers (by piercing the corporate veil or ignoring "dummy" instrumentalities) against liability of persons who may in fact have caused a violation. Hence, the standards adopted by those provisions are irrelevant to the civil liability of the broker-dealer firm for the frauds of its employees, committed within the scope of their employment.

Because of the national character of the securities market and because Congress has enacted comprehensive federal legislation in this field, the civil responsibility of a broker-dealer for its employees' violations of federal antifraud provisions should be governed by uniform federal standards.

In implementing the remedial purposes of the securities laws, the Securities and Exchange Commission holds a broker-dealer necessarily subject to administrative discipline for the fraudulent activities of its employees while acting within the scope of their employment. Similar considerations also warrant holding the firm liable in damages as a matter of course to a person defrauded in such circumstances. The

federal securities laws were passed to give public investors special protection against their own gullibility. It is inconsistent with this federal policy to impose upon persons dealing with a broker-dealer's agent a duty of investigation into possible limits of his authority. Although greater sophistication may be expected in this connection from other broker-dealers than from ordinary public investors, the practical realities of the interdealer market make the duty of investigation imposed by court below inappropriate even in this context. Accordingly, the court of appeals erred as a matter of law in denying recovery to petitioner because it had failed to investigate the authority of the respondents' agents to engage in the transactions by which petitioner was defrauded.

ARGUMENT

I. THE LIABILITY OF A BROKER-DEALER FIRM FOR VIOLATIONS OF THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS BY EMPLOYEES OF THE FIRM, ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT, IS NOT GOVERNED OR RESTRICTED BY THE "CONTROLLING-PERSONS" PROVISIONS OF THOSE LAWS

In accordance with principles long followed by the Securities and Exchange Commission, as we shall elaborate (*infra*, pp. 20–27), petitioner premised his federal claims primarily and explicitly (R. 2, 10, 26, 42, 45) upon the theory that the antifraud provisions of Section 12(2) and 17(a) of the 1933 Act, Sections 10(b) and 15(c)(1)–(3) of the 1934 Act, and the pertinent rules under the latter act, impose a "nondelegable

duty" upon a securities firm to comply with those provisions in its business; and that the violations by Ross and Grossinger, which were committed in the regular course of their employment and in the name of and for the profit of the respondent firm, were necessarily violations by the firm as well. Petitioner thus relied directly upon the express remedy contained in Section 12(2) of the 1933 Act and upon private rights of action that have regularly been implied against persons who have violated the other antifraud provisions.[6]

The court of appeals, however, did not attempt to determine whether the respondent firm and its partners were directly liable under the antifraud provisions for violations of those provisions. Rather, it bypassed the independent force of these sections and instead concentrated on the controlling-persons provisions of Section 15 of the 1933 Act and Section 20(a) of the 1934 Act, treating the standards in these two sections as the exclusive basis for imputing to a broker-dealer the responsibility for statutory violations by its employees. Thus, it construed the controlling-persons provisions as generally precluding a broker-dealer's liability for the frauds of its employees

[6] This Court has held that private rights of action are to be implied for violations of another provision of the securities acts. *J. I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 430–434; cf. *Wyandotte Co.* v. *United States*, 389 U.S. 191, 201–202. The courts of appeals have implied private rights of action under the antifraud provisions involved in this case. *E.g.*, *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2).

except when certain unspecified principals of the firm are personally at fault.[7]

We submit, on the contrary, that the controlling-persons provisions under which the court analyzed the federal aspect of petitioner's claim are essentially irrelevant in the ordinary employer-employee context, as exists in this case. These provisions were designed to reach situations in which there are technical legal barriers between the persons in fact responsible for violations of the securities acts and those injured by the violations. As we discuss below, the controlling-persons provisions were designed to avoid those barriers by, for example, piercing the corporate veil to reach controlling stockholders. They were intended to enlarge, not restrict, the scope of vicarious liability otherwise arising under the securities acts. Hence, the exceptions set forth in those provisions are applicable only when it is necessary to invoke these expanded premises of liability. Conversely, they are not applicable here because respondents' liability may be and

[7] Both the antifraud sections and the controlling-persons provisions speak of the duties and liabilities of a "person". This term is defined by both acts (Section 2(2) of the 1933 Act, 15 U.S.C. 77b(2), and Section 3(a)(9) of the 1934 Act, 15 U.S.C. 78c(a)(9)) to include a "corporation," a "partnership" and other legal entities. Thus, fraud-doers and controlling persons are not limited to natural persons but include legal entities as well. Since a corporation or a partnership cannot itself have knowledge or reason to know of facts or act in good faith, the exceptions in the controlling-persons provisions can be applied to such legal entities only insofar as the knowledge, reason to know, or good faith of certain individuals is imputed to them. The controlling-persons provisions do not themselves provide any rules for identifying these individuals.

should be determined directly under the antifraud provisions themselves.

The legislative history of the controlling-persons provisions supports this analysis of their precise focus. The original Senate version of the 1933 Act contained a number of provisions designed "to aid in preventing directors from evading the liabilities incident to signing the registration statement * * *."[8] This draft of the Act dealt with the use of a "dummy" signer[9] of a registration statement and made the fraudulent use of a "dummy" unlawful.[10] The House version, which contained registration and antifraud provisions very much like those eventually adopted, contained no sections expressly dealing either with "dummies" or with controlling persons.[11] In conference these "'dummy provisions' which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the

[8] S. Rep. No. 47, 73d Cong., 1st Sess. 5.

[9] "Dummy" was defined to mean "a person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligation to act therein in accordance with the direction of another." S. 875, § 2(k), 73d Cong., 1st Sess. (April 17, 1933), 77 Cong. Rec. 2979.

[10] The bill required the "dummy" signer to disclose his capacity and the identity of his principal or principals; it provided that a "dummy's" signature would be invalid unless accompanied by the signature of his principal, and (in the provision that eventually became Section 17(a)) it made it unlawful to employ a "dummy" to defraud, providing that both the "dummy" and the principal would be violators. *Id.* §§ 4, 13.

[11] H.R. 5480, 73d Cong., 1st Sess. (May 4, 1933).

actual control exercised by one party over the other * * * [were] welded into one and incorporated as a new section in the substitute." [12] The "new section" is what is now the controlling-persons provision of Section 15. Thus, that section was the result of congressional concern with the special problem presented by the use of "dummies", and was not designed to govern the usual employment situation.

The legislative history of Section 20(a) of the 1934 Act indicates that the same Congress that had passed the 1933 Act continued to understand the controlling-persons provisions as applying only in these special circumstances. In describing the provision that eventually became Section 20(a), Thomas C. Corcoran, one of the authors of the 1934 Act, testified: "The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section." [13] Although the 1934 Act always contained provisions for the regulation of broker-dealers, Section 20(a) was not thought to have much relevance in that context. Richard Whitney, then President of the New York Stock Exchange, stated that "[t]hese provisions seem to apply more particularly to corporations and officers, directors, and stockholders of corporations than to exchanges or brokers." [14] There is no suggestion in the legislative history of the 1934

[12] H. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27.

[13] *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st Sess. 6571.

[14] *Id.* at 6639.

Act that Congress contemplated that Section 20(a) could or would be invoked to shield broker-dealers from responsibility for the acts of their employees within the scope of their employment.[15]

The approach adopted in the controlling-persons provisions departs from traditional agency law, and for this reason it is inconceivable that Congress, without giving the slightest expression of such a purpose, intended that the controlling-persons provisions supersede all other principles of agency that would otherwise have applied under the securities laws. To observe the difference in approach we need only turn to the current edition of the Agency Restatement, upon which the court of appeals placed great reliance in analyzing the pertinent California law. The Restatement provides that "[a] principal, although personally innocent, is liable * * ** for the misrepresentations of his agent if actually authorized, apparently or ostensibly authorized, or within his agency powers."[16]

---

[15] The exception contained in Section 15 of the 1933 Act and relied upon by the courts below to exculpate respondents was also added to that section at the time of passage of the 1934 Act. The purpose of this amendment was only "to carry out * * * [the] real purpose" of Section 15 without making "[t]he *mere existence of control* * * * a basis for liability if it is shown that the controlling person had no knowledge * * * to believe in the existence of the facts upon which the liability of the controlled person is * * * based." H. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 42 (emphasis added). As discussed more fully at pages 21–24, *infra*, there is more involved than the "mere existence of control" when broker-dealer firms entrust their employees with authority to deal with the public for the profit of the firm in transactions far beyond the employees' own financial resources.

[16] *Restatement* (*Second*), *Agency*, §§ 257 and Comment *b*, 261 and Comment *a* (1957).

Apparent or ostensible authority exists if the third party "reasonably believes from conduct for which the principal is responsible that the agent is authorized to make the representations as made." [17] The controlling-persons provisions of the securities acts, on the other hand, do *not* impose responsibility even when actual or apparent authority is present, if the controlling person is personally innocent. The allowance of this defense in the controlling-persons sections is consistent with the congressional purpose of tempering its *extension* of vicarious liability by allowing such a person to demonstrate his personal freedom from fault. But to follow the unstated premise of the courts below that the standards of these new provisions exclusively control the possibility of imputed liability under other sections of the securities laws would mean, as their decisions reflect, that the federal securities laws would provide *less* protection for persons defrauded by employees of broker-dealer firms than does state law.[18]

This anomalous consequence would unjustifiably offend the policy that the federal securities laws constitute remedial legislation, to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Bureau*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S.

[17] *Id.* § 257, Comment *a*; § 258 and Comment *c*; § 261.

[18] The rules of agency discussed in the text were substantially the same under the original edition of the Restatement, which was published in 1933. *Restatement, Agency* §§ 257 and Comments *a–b*, 258 and Comment *c*, 261 and Comment *a*.

332, 336. Their text should be interpreted "so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *Securities and Exchange Commission* v. *Joiner Corp.*, 320 U.S. 344, 351 (footnote omitted). The securities acts were passed to expand common law liabilities, not to contract them.[19]

Since, therefore, the standards contained in the controlling-persons sections were not intended to govern where other principles of imputed liability exist, the question then becomes: What are the proper standards of vicarious liability for a broker-dealer under the antifraud provisions of the federal securities laws?

II. A VIOLATION OF THE ANTIFRAUD PROVISIONS OF THE SECURITIES ACTS BY A BROKER-DEALER'S EMPLOYEES, ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT, IS NECESSARILY A VIOLATION BY THE FIRM ITSELF

A. A BROKER-DEALER'S RESPONSIBILITY UNDER THE FEDERAL SECURITIES LAWS IN SUCH CIRCUMSTANCES SHOULD BE DETERMINED AS A MATTER OF UNIFORM FEDERAL LAW IN ACCORDANCE WITH THE UNDERLYING STATUTORY PURPOSES

Congress enacted legislation in this field because it recognized that "traffic in investment securities"[20] is nationwide in character. As stated in the legislative findings in the 1934 Act, securities transactions are "affected with a national public interest * * *", "in

[19] This is illustrated by the fact that Congress deliberately made the express liability provisions in the securities acts more sweeping than the common law; *e.g.*, proof of scienter and reliance are not required under Section 11 of the 1933 Act, 15 U.S.C. 77k, or under Section 12(2) of that Act.

[20] Message from the President of the United States, H. Doc. No. 12, 73d Cong., 1st Sess. 1.

large part originate outside the States in which the exchanges and over-the-counter markets are located * * *", and "constitute an important part of the current of interstate commerce * * *."[21] Many broker-dealers have branch offices throughout the United States, and it is the Commission's experience that in our mobile society the public customers of these firms increasingly tend to utilize these local branch offices as they move about the country for business or pleasure.[22] As in this case, broker-dealers and other professional investors frequently transact their business by long distance telephone.

Given the national character of the securities business and the national plan of regulation, the responsibility of the firm under the federal securities acts should not turn on such fortuitous factors as the place of contracting or the venue of the particular action. Such a rule "would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain." *Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 367. The customer of a

[21] Section 2, 15 U.S.C. 78b.

[22] In 1950, members of the National Association of Securities Dealers, Inc. (about 90 per cent of the broker-dealers in the country), had 1321 branch offices in the United States, less than a third of the total number of brokerage offices. By 1962 the number of branch offices had risen to 4713, which was almost equal to the number of main offices. In 1962 there were nearly twice as many branch offices as main offices in the State of California, the location of petitioner's sole office. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 29–30.

broker-dealer should not be required to consult a local attorney in order to know when the securities firm can be expected to stand behind its employees, and when he must make further inquiry. See, also, *D'Oench Duhme & Co.* v. *Federal Deposit Insurance Corporation,* 315 U.S. 447, 471–472 (concurring opinion).

Thus, the Court has frequently eschewed state law as the basis for filling in the interstices of the federal securities acts. *E.g., Tcherepnin* v. *Knight, supra,* 389 U.S. at 337–338; *Securities and Exchange Commission* v. *Variable Annuity Co.,* 359 U.S. 65, 69; cf. *Brown* v. *Bullock,* 294 F. 2d 415 (C.A. 2).[23] Similar treatment is called for here.

As the Court explained in the *Borak* case, *supra,* 377 U.S. at 434, "it 'is not uncommon for federal courts to fashion federal law where federal rights are concerned.' "[24] When these rights are generally set forth in a federal statute, the starting point for supplying any missing details is the motivating purpose of that statute. Problems "in the penumbra of express statutory mandates" are to "be solved by looking at the policy of the legislation and fashioning a remedy

[23] On occasion the courts have looked to state laws. For example, since the securities acts contain no statute of limitations applicable to implied private rights of action, the courts have used relevant state limitations. Even in this situation, however, the federal fraudulent concealment rule has been engrafted upon the state statutes of limitations. *E.g., Azalea Meats, Inc.* v. *Muscat,* 386 F. 2d 5 (C.A. 5); *Janigan* v. *Taylor,* 344 F. 2d 781 (C.A. 1), *certiorari denied,* 382 U.S. 879.

[24] Quoting from *Textile Workers* v. *Lincoln Mills,* 353 U.S. 448, 457.

that will effectuate that policy." *Textile Workers* v. *Lincoln Mills, supra,* 353 U.S. at 457; cf. *Frost & Co.* v. *Mines Corp.,* 312 U.S. 38, 43–45. Indeed, in matters of remedy the federal statutory purpose is particularly the touchstone for formulating the necessary federal common law. "[I]t is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 433. Restrictive state laws cannot be allowed to frustrate the provision of adequate relief for violations of federal law. As the Court said in *Sola Electric Co.* v. *Jefferson Co.,* 317 U.S. 173, 176, and reiterated in *Borak, supra,* 377 U.S. at 433:

> When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield. * * *

Cf. *Pope & Talbot, Inc.* v. *Hawn,* 346 U.S. 406, 408–410.

B. THE OVERRIDING OBJECTIVES OF THE SECURITIES LAWS WOULD BEST BE ADVANCED BY HOLDING BROKER-DEALERS LIABLE AS A MATTER OF COURSE FOR THE FRAUDS OF THEIR EMPLOYEES PRACTICED WITHIN THE SCOPE OF THEIR EMPLOYMENT

We submit that the interests that Congress sought to protect when it enacted the 1933 and 1934 securities acts can be effectively promoted only by recognizing

that broker-dealers are as a matter of courses responsible in damages to persons whom their employees have defrauded in connection with their employment with the firm. Because of the pervasive prophylactic purposes of the federal legislation, broker-dealers should be held to a rigorous standard of responsibility for the acts of their employees, without resort to such nice refinements of common law agency principles as "apparent" or "ostensible" authority.

The securities acts were passed because it was recognized that investors needed protection in securities transactions. In transmitting to Congress his recommendation for legislation in this field, the President wrote: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.'"[21] Securities are "intricate merchandise,"[22] and Congress recognized that the common law rules developed to deal with transactions involving property of a more traditional nature were inappropriate to the sophisticated transactions involving securities. As the Court said in the *Capital Gains* case, *supra*, 375 U.S. at 195:

> "[I]t would be logical to conclude that Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels."

[21] H. Doc. No. 12, 73d Cong., 1st Sess. 1.
[22] H. Rep. No. 85, 73d Cong., 1st Sess. 8.

Thus, it does not follow that a securities trader should not be held liable merely because a horse trader might escape liability in a similar situation.

In its administrative disciplinary proceedings the Commission has long recognized this crucial distinction and has invariably held that a violation of the securities laws by officers or employees of a broker-dealer firm acting within the scope of their employment is necessarily a violation by the firm itself, and that the degree of fault on the part of the firm is a factor to be considered only in determining the sanction, if any, to be imposed. *E.g., Cady, Robert & Co.*, 40 S.E.C. 907, 911; *H. F. Schroeder & Co.*, 27 S.E.C. 833, 837; *E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 379 and n. 45; cf. *National Association of Securities Dealers, Inc.*, 20 S.E.C. 508, 515–516.[27] This is in accord with the well established principle that a corporation or a partnership may be held liable and, indeed, criminally responsible for the acts of its officers or employees within the scope of their employment. The policy underlying this principle is that:

> The business entity cannot be left free to break the law merely because its owners, stockholders * * * [or] partners * * * do not personally participate in the infraction. The treasury of the business may not with impunity obtain the fruits of violations which are committed knowingly by agents of the entity in the scope of their employment. [Footnote omitted.]

[27] The Commission is also authorized to proceed directly against individual officers or supervisory employees of the firm who failed to supervise adequately the actual wrongdoers. Section 15(b)(5)(E) of the 1934 Act, 15 U.S.C. 78o(b)(5)(E).

United States v. *A & P Trucking Co.*, 358 U.S. 121, 126 (partnershsip); accord, *New York Central R.R. v. United States*, 212 U.S. 481 (corporation). See, also, *Egan* v. *United States*, 137 F. 2d 369, 379 (C.A. 8), certiorari denied, 320 U.S. 788.

There is no sound reason why this same rule should not obtain in the realm of a civil suit where the person actually injured by the fraud seeks to be made whole by the firm with which he was dealing. Many, probably a majority, of the frauds practiced by securities firms involve misconduct by employees—typically by sales representatives who make false or unfounded representations with respect to securities. It is the Commission's experience that from time to time salesmen actually whet the appetites of gullible public customers by representing that they are breaking their employers' rules by giving them a special deal; for example, by giving them more than the prescribed quota of a new issue of securities. But, whatever the representations made by the salesmen or other employees of the broker-dealer, we have found that investors customarily rely primarily on the integrity, reputation, and responsibility *of the firm itself* rather than on the character of the particular employee with whom they happen to be dealing. It is the firm that is accepting and retaining the profits from the transactions, as Kamen & Co. did in this case; and it is the firm to whom the customer should be permitted and expected to look if his trust has been abused.

When a securities firm confers upon its employees the authority to engage in transactions far beyond

the financial resources of the individual employees, public investors should not be required to ponder whether that firm has also given those employees confidential instructions limiting that authority, or be required to abstain from participation in a securities transaction without first consulting a managing partner to ascertain the metes and bounds of the authority of the firm's representative. Members of the investing public who deal with a securities firm should be entitled to assume that the firm will stand behind the conduct of the employees it retains to deal with the public when they act within the scope of their employment.[28] A broker dealer's responsibility for the acts of its employees could not be expressly waived by the customer.[29] Neither should an indirect waiver be sanctioned in the form of an unwarranted duty of investigation. At the very least, an ordinary public investor who relies on the representations of an employee should never be held to a duty to determine at his peril the extent of the employee's authority, *vel non*, to obtain his participation in a particular transaction.

It is true, of course, as respondents will no doubt argue, that greater sophistication can be expected of broker-dealers and other professionals than of ordinary members of the investing public, and that egre-

[28] We repeat that the courts below concurred in finding that Ross and Grossinger conducted their fraudulent operations within the scope of their employment (R. 50, 56, 67–68).

[29] Section 14 of the 1933 Act, 15 U.S.C. 77n, and Section 29(a) of the 1934 Act, 15 U.S.C. 78cc(a), invalidate waivers of the protection of the securities acts. See, generally, *Wilko v. Swan*, 346 U.S. 427.

giously irregular circumstances should alert the professional not to rely on the employee's affiliation with a respectable firm without investigating his authority in the matter. Nevertheless, the securities acts were not designed to protect only the ordinary public investor; they were intended to protect all persons who purchase and sell securities.[30] It would not be conducive to the remedial objectives of the securities laws to exonerate broker-dealers from responsibility for the business-connected frauds of their employees merely because the person who relied in good faith on the representations happened also to be a professional. Securities transactions in the interdealer market are often much more complicated than those involving ordinary public investors.[31] Furthermore, holding even a professional responsible for investigating the authority of the employee of another firm could be disruptively impractical.

---

[30] On this basis it has been held that a private right of action will be implied in favor of a broker-dealer that has been defrauded by its customer. *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393 (C.A. 2); cf. *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814.

[31] In this case, for example, the court of appeals determined that petitioner could not rely on "ostensible" authority on the part of Ross and Grossinger because, in the court's view, the transaction being arranged violated New York Stock Exchange Rules. See note 32, *infra*. This is an area, however, where "fine" distinctions have grown up in the interpretation of the Stock Exchange's minimum commission rules in transactions with broker-dealers and other professional investors. *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, at 301–311; Pt. 4, at 223–227. The Commission has recently noted the "complex practices" that have been developed by member firms to give rebates to professional investors. Securities Exchange Act Release No. 8239, at 3–4 (Jan. 26, 1968).

Trust and confidence are the essence of transactions between broker-dealers, who often must commit large sums solely on the basis of a gesture, a handshake or, as in this case, a telephone call. These transactions are often of necessity concluded in a matter of seconds, and there is no opportunity to investigate without risking a price change in a rapidly fluctuating market or losing the transaction altogether. Therefore, even as to broker-dealers and other professional investors, the imposition of a strict duty to investigate the authority of the employee would be inconsistent within the underlying statutory purposes and the realities of the securities market. Petitioner should not be precluded from holding Kamen & Co. and its partners responsible for the fraud of Ross and Grossinger merely because it failed to investigate their authority.[22]

The securities acts were designed to protect all investors, both the gullible and the sophisticated. This

[22] There is no contention that petitioner actually knew that Ross and Grossinger were without authority to engage in these transactions. It is, therefore, unnecessary for the Court to determine whether such actual knowledge would be a valid defense in the case of a public investor, a broker-dealer, or both. Nor is there any issue before the Court whether the customer of a broker-dealer who is a knowing participant in a violation of the securities acts or a stock exchange rule designed to protect the public would be barred, as *in pari delicto*, from recovering against even the firm's employees. The only violation about which the court below charged petitioner with knowledge was a violation of the New York Stock Exchange's minimum commission rule, which is designed primarily to insure the profitability of exchange transactions for its members, not to protect the public from injurious practices. Cf. *Colonial Realty Corp.* v. *Bache & Co.*, 358 F. 2d 178 (C.A. 2), certiorari denied, 385 U.S. 817.

remedial purpose can best be advanced by holding those engaged in the securities business to a rigorous standard of responsibility for fraudulent activities of their employees committed within the scope of their employment.

CONCLUSION

For the reasons stated above, the judgment of the court of appeals should be reversed and the case remanded to determine petitioner's damages.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

PHILIP A. LACOVARA,
Assistant to the Solicitor General.

PHILIP A. LOOMIS, JR.,
General Counsel,

DAVID FERBER,
Solicitor,

ROGER S. FOSTER,
Special Counsel,

DONALD M. FEUERSTEIN,
Special Counsel,

WARREN K. MORGENS,
Attorney,
Securities and Exchange Commission.

MAY 1968.